

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D120/02

Salaries tax – whether salaries tax is chargeable on the notional gain realized by an employee's exercise of his or her right to acquire shares at a discount offered by his or her employer – what is the relevant time in determining the amount which a person might reasonably expect to obtain from a sale in the open market – two conflicting lines of authorities – what is the time the appellant had acquired the shares – the distinction between a share certificate and a share – absence of any share certificate does not negate the acquisition of the shares – the notional sale relates to the bundle of rights which the employee obtained by virtue of his or her employment – once it is concluded that the employee did acquire rights on a particular day, he is deemed by section 9(4)(a) to have disposed of those rights – the nature of the rights (together with the restrictions attached thereto) would of course be relevant in determining the amount 'which a person might reasonably expect to obtain from a sale in the open market' – section 9(1)(d) and 9(4)(a) of the Inland Revenue Ordinance ('IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Patrick Ho Pak Tai and Edmund Leung Kwong Ho.

Date of hearing: 11 November 2002.

Date of decision: 15 February 2003.

The appellant, an assistant manager with a bank ('the Bank'), had subscribed for 60 shares under the discounted share purchase plan ('the Plan') offered by the Bank.

There was no evidence before the Board as to the precise date when the appellant exercised her right to acquire the shares. The appellant was given an additional 16 free shares according to the terms of the Plan. On the issue date, a total of 76 shares were allocated to the appellant.

The appellant was assessed \$19,067 under section 9(1)(d) of the IRO as the gain realized by her exercise of the right to acquire the shares.

The appellant appealed against the assessment so raised on the grounds that:

- (a) Her right was to acquire 'forward' shares. She had yet acquired any share. Her case was therefore not covered by the authorities cited by the Revenue.

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- (b) Given the fact that no certificate in respect of the shares would be delivered to her until the end of the holding period, there could not be any notional sale under section 9(4)(a).

The facts appear sufficiently in the following judgment.

Held:

1. The relevant statutory provisions were contained in section 9(1)(d) and 9(4)(a) of the IRO.
2. There were two conflicting lines of authorities:
 - (a) The first line of authorities (D14/90; D4/91; D66/94 and D128/99) supported the view that the relevant time in determining the amount which a person might reasonably expect to obtain from a sale in the open market was the time when such right was exercised. The notional sale envisaged by section 9(4)(a) would take place on that date. As the section made no reference to the taxpayer being able to deal in shares, the absence of any certificate did not prevent the operation of the notional sale.
 - (b) The second line of authorities (D43/99) held that the relevant time was 'when the shares were acquired'. It presupposed that no share was acquired at the time when the option was exercised. It maintained that despite the possible acquisition of the shares, the non-availability of any certificate was to be taken into account in determining whether there could be a notional sale.
3. There was no direct evidence as to the precise date when the appellant exercised her right in this case.
4. It was therefore unnecessary for the Board to embark upon the unenviable task of choosing between the two conflicting lines of authorities.
5. In deciding whether the appellant acquired any share on 12 July 2000, it was pertinent to note paragraph 14.1 of Gore-Browne on Companies:

'A share is the interest of a shareholder in the company, measured by a sum of money for the purpose of liability in the first place and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with s. 16 of the Companies Act

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1962 ... A share is not a sum of money ... but is an interest measured by a sum of money, and made up of various rights contained in the contract'.

6. Paragraph 16.7 of Gore-Browne on Companies further pointed out that:

'A certificate under the common seal ... is, so far as English law is concerned, prima facie evidence of the title of the person named to the shares ...'.

'A share certificate (as opposed to the share itself which is a chose in action) is a personal chattel and can be the subject of a claim in conversion at the suit of someone who has either possession or an immediate legal right to possession at the time of conversion'.
7. Given the distinction between a share certificate and a share and the terms of the Plan, the Board had no doubt that by 12 July 2000 (if not earlier) the appellant had acquired 76 shares.
8. The appellant was the legal owner of the 76 shares. Her name was entered on the Register of Shareholders. She was entitled to the dividends attributable to and the voting rights attached to the shares.
9. The appellant's right to sell the shares was however curtailed in that the same may not be sold for five years from the date of her acquisition.
10. This bundle of rights and obligations was vested in the appellant on 12 July 2000. These were valid and subsisting rights. These rights were of value although they may not be as valuable as rights which were totally unfettered.
11. The non-availability of the share certificate did not prevent the vesting of these rights in the appellant on 12 July 2000. The Board therefore rejected the appellant's contention that she did not acquire the shares on 12 July 2000.
12. Once the Board concluded that the absence of any share certificate did not negate the acquisition of the shares, the Board found it difficult to see why the absence of the share certificate should be relevant in considering the viability of a notional sale.
13. The notional sale related to the bundle of rights which the employee obtained by virtue of his or her employment.
14. Once it was concluded that the employee did acquire rights on a particular day, he was deemed by section 9(4)(a) to have disposed of those rights.

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15. The nature of the rights (together with the restrictions attached thereto) would of course be relevant in determining the amount 'which a person might reasonably expect to obtain from a sale in the open market'. That was a valuation exercise to be undertaken in the light of the facts of each particular case.
16. The rights in this case were rights to receive dividends and to vote in a leading bank. Those rights were subject to a five years' restriction against alienation.
17. The Revenue and the Bank were ad idem that the market price of the shares as at 12 July 2000 should be discounted by 20% to reflect such restrictions.
18. There was however evidence before the Board indicating that the United Kingdom Capital Taxes Office was prepared to allow a 25% discount to 'reflect the five year restriction period with early release clauses'.
19. The Revenue had not furnished any reason to differentiate the Hong Kong and the United Kingdom positions.
20. The Board was of the view that a 20% discount was too low in the circumstances.
21. Despite express invitation by the Board, the appellant did not put forward any other figure.
22. The Board would follow the English position and direct that tax should be assessed on the basis of a 25% discount of the market value on 12 July 2000.
23. The Board allowed the appeal to the extent as aforesaid indicated. Save and to the extent as aforesaid indicated, the Board confirmed the assessment on the appellant.

Appeal allowed in part.

Cases referred to:

D14/90, IRBRD, vol 5, 131
D4/91, IRBRD, vol 5, 542
D66/94, IRBRD, vol 9, 373
D43/99, IRBRD, vol 14, 448
D128/99, IRBRD, vol 15, 16

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Simon Lau Government Counsel of Department of Justice for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

Background

1. The Appellant was an assistant manager with a bank ('the Bank').
2. In May 2000, the Bank offered its then employees participation in its discounted share purchase plan ('the Plan'). The Bank's employees were offered the Bank's shares ('the Shares') at 65 Euro per Share on the basis of a discount of 20% to the market value of the Shares as fixed by the board of the Bank. Employees of the Bank were told that:
 - (a) 'You can subscribe up to one quarter of your annual total cash compensation with a maximum subscription of 450 shares'.
 - (b) 'Your Employing Company will also subscribe for further Shares on your behalf'.
 - (c) 'Your Plan Shares must be held and may not be sold or transferred for 5 years from the date of acquisition (except in cases of certain early release conditions)'.
 - (d) 'You will own your Plan Shares immediately on allocation and you will be entitled to any dividends and voting rights attached to them'.
 - (e) 'You may be subject to an income tax liability ... on allocation of the Plan Shares'.
 - (f) 'You will be able to subscribe for Shares ... between 2 June 2000 and ... 22 June 2000'.
 - (g) 'Your Plan Shares (including the "Free" Shares) will be allocated to you on 12 July 2000 ("Issue Date")'.
 - (h) 'You will be the legal owner of the Plan Shares and your name will be entered on the Company's Register of Shareholders. Your Plan Shares will be held on

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your behalf in registered form in the Company's Register for the Holding Period'.

3. The Appellant subscribed for 60 Shares. There is no evidence before us as to the precise date when she exercised her right. The Appellant was given an additional 16 Free Shares according to the terms of the Plan. On the Issue Date, a total of 76 Shares were allocated to the Appellant.

4. The Appellant was assessed \$19,067 under section 9(1)(d) of the IRO as the gain realized by her exercise of the right to acquire the Shares. According to the Revenue, that sum was arrived at in accordance with section 9(4)(a) of the IRO as follows:

(a) The amount of the consideration given for the 76 Shares

$$\begin{aligned} & 60 \times \text{EUR } 65 \\ = & \text{EUR } 3,900 \\ = & \text{HK\$}28,636.14. \end{aligned}$$

(b) The amount which the Appellant might reasonably expect to obtain from a sale in the open market on 12 July 2000 being 'that time of the shares ... acquired'

Market value of 76 Shares \times 80% on the basis that the Shares were not alienable save in special circumstances within a period of five years

$$\begin{aligned} = & \text{EUR } 106 \times 76 \text{ Shares} \times 80\% \\ = & \text{HK\$}47,703.77. \end{aligned}$$

(c) Difference between (b) and (a)

$$\begin{aligned} & \text{HK\$}47,703.77 - \text{HK\$}28,636.14 \\ = & \text{HK\$}19,067.63. \end{aligned}$$

5. This is the Appellant's appeal against the assessment so raised. The Appellant makes two points:

(a) Her right was to acquire 'forward' shares. She has yet acquired any Share. Her case is therefore not covered by the authorities cited by the Revenue.

(b) Given the fact that no certificate in respect of the Shares would be delivered to her until the end of the Holding Period, there could not be any notional sale under section 9(4)(a).

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The statutory provisions

6. Section 9(1)(d) of the IRO provides that:

‘Income from any office or employment includes ... any gain realized by the exercise of ... a right to acquire shares ... in a corporation obtained by a person as the holder of an office in or an employee of that or any other corporation’.

7. Section 9(4)(a) of the IRO provides that:

‘For the purposes of subsection (1) ... the gain realized by the exercise at any time of such a right as is referred to in paragraph (d) of that subsection shall be taken to be the difference between the amount which a person might reasonably expect to obtain from a sale in the open market at that time of the shares ... acquired and the amount or value of the consideration given whether for them or for the grant of the right or for both’.

The decided cases

8. In D14/90, IRBRD, vol 5, 131, the taxpayer exercised his option to purchase shares on 5 October 1987 at 82.5 pence when the market price of the shares was at 140 pence. The shares were allotted to him on the same day. The share certificates were however not posted from England to the taxpayer until 3 November 1987. They were not received by the taxpayer until 17 November 1987. The taxpayer gave instructions to sell the shares on 18 November 1987 and the shares were eventually sold on 8 January 1988 at 82 pence. The taxpayer argued that he could not have sold the shares until after he had received the share certificates in Hong Kong and he should not be assessed to tax on a notional benefit which he had not in fact received. The Board rejected this argument. The Board pointed out that:

‘The Inland Revenue Ordinance makes no reference to the Taxpayer being able to deal in shares. Instead section 9(4)(a) specifically refers to “the exercise at any time of such a right” and then relates the notional sale back to that time. Accordingly the wording of the Ordinance is quite clear and the notional gain must be calculated as at the date when the Taxpayer exercised the share option to which he was entitled. That was clearly 5 October 1987 and no other date’.

9. In D4/91, IRBRD, vol 5, 542 the appellant exercised his option on 15 September 1988. Following his exercise of the option, the appellant sold the shares at a profit. The Revenue argued that the gain had to be computed at the time of exercise of the right and not when the shares were sold. The Board held that:

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'... the Inland Revenue Ordinance seeks to tax a notional gain and not an actual gain. However, the notional gain is not an academic gain but is stated by the Inland Revenue Ordinance to be the amount which a person might reasonably expect to obtain from a sale in the open market at the time when he exercises the option. The section of the Ordinance does not relate to the date on which the option is exercised. It relates to the "time" when the option is exercised. In our opinion, the use of the word "time" as opposed to the word "date" and the inclusion of the words "which a person might reasonably expect to obtain" mean that one is to take a realistic attitude and not a theoretical attitude. One is to look at the question in reality and in substance. One must decide what a person could reasonably expect to have received if he had exercised the option and sold the shares as quickly as possible in the open market'.

10. In D66/94, IRBRD, vol 9, 373, the taxpayer effectively exercised his option to subscribe for shares on 27 May 1992. He did not receive the certificates until July 1992. The shares were sold between 6 August 1992 and 30 November 1992. The taxpayer submitted that he should be taxed on his actual profit. The Board, following the decision in D14/90, rejected this argument and held the relevant date to be the date when he exercised the option. There was no argument that the relevant date should be the date when he received the certificates.

11. These authorities were reviewed by the Board in D43/99, IRBRD, vol 14, 448. The taxpayer exercised his option to purchase shares in a company of which he was the vice-chairman on 23 June 1993. The option shares were allotted by the company in favour of the taxpayer on 25 June 1993. The company was informed by the Central Registration of Hong Kong Limited that the certificates were available on 6 July 1993. The taxpayer took delivery of those shares on 9 July 1993. The Board compared the English and Chinese texts of section 9(4)(a) of the IRO and came to the view that in assessing the amount which a person might reasonably expect to obtain from a sale in the open market, the material time is the time when the shares were acquired as opposed to the time when the right was exercised. On the basis of the evidence before them, the Board held that the shares could not possibly be acquired before 25 June 1993 when the shares were allotted in favour of the taxpayer. The Board went further and said that *'Even if we hold that the shares were acquired at the time the Board resolved to allot the shares, that is on 25 June 1993, there could not be a notional sale and thus no notional gain when the share certificate had not been issued'*. The Board concluded that 6 July 1993 was the material date as that was *'the earliest time the Taxpayer could theoretically have sold his shares ... as the share certificate was available'*.

12. In D128/99, IRBRD, vol 15, 16, three dates (date of exercise of the options, date when relevant certificates issued and date when relevant certificates obtained) were canvassed before the Board. The first of those three dates was the one most favourable to the taxpayer. There was therefore no argument in favour of the two later dates. The taxpayer however

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contended that he should be assessed on the basis of his actual sale proceeds as he was prevented by the Listing Rules from selling the shares prior to their eventual sales. The Board however rejected this contention holding that *'As the assessment is based on a notional gain, the fact that the Taxpayer did not in fact realize such gain because of circumstances beyond his control is not a relevant consideration'*.

13. There are therefore two conflicting lines of authorities:
- (a) The first line of authorities (D14/90; D4/91; D66/94 and D128/99) supports the view that the relevant time in determining the amount which a person might reasonably expect to obtain from a sale in the open market is the time when such right is exercised. The notional sale envisaged by section 9(4)(a) would take place on that date. As the section makes no reference to the taxpayer being able to deal in shares, the absence of any certificate does not prevent the operation of the notional sale.
 - (b) The second line of authorities (D43/99) holds that the relevant time is 'when the shares were acquired'. It presupposes that no share was acquired at the time when the option was exercised. It maintains that despite the possible acquisition of the shares, the non-availability of any certificate is to be taken into account in determining whether there could be a notional sale.

14. As pointed out above, there is no direct evidence as to the precise date when the Appellant exercised her right in this case. It is therefore unnecessary for us to embark upon the unenviable task of choosing between the two conflicting lines of authorities.

Did the Appellant acquire any Share on 12 July 2000

15. As indicated by paragraph 14.1 of Gore-Browne on Companies:

'A share is the interest of a shareholder in the company, measured by a sum of money for the purpose of liability in the first place and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with s. 16 of the Companies Act 1962 ... A share is not a sum of money ... but is an interest measured by a sum of money, and made up of various rights contained in the contract'.

16. Paragraph 16.7 of Gore-Browne on Companies further pointed out that:

'A certificate under the common seal ... is, so far as English law is concerned, prima facie evidence of the title of the person named to the shares ...'.

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'A share certificate (as opposed to the share itself which is a chose in action) is a personal chattel and can be the subject of a claim in conversion at the suit of someone who has either possession or an immediate legal right to possession at the time of conversion'.

17. Given the distinction between a share certificate and a share and the terms of the Plan, we have no doubt that by 12 July 2000 (if not earlier) the Appellant had acquired 76 Shares. She is the legal owner of the 76 Shares. Her name is entered on the Register of Shareholders. She is entitled to the dividends attributable to and the voting rights attached to the Shares. Her right to sell the Shares is however curtailed in that the same may not be sold for five years from the date of her acquisition. This bundle of rights and obligations was vested in the Appellant on 12 July 2000. These are valid and subsisting rights. These rights are of value although they may not be as valuable as rights which are totally unfettered. The non-availability of the share certificate does not prevent the vesting of these rights in the Appellant on 12 July 2000. We therefore reject the Appellant's contention that she did not acquire the Shares on 12 July 2000.

The notional sale

18. Once we conclude that the absence of any share certificate does not negate the acquisition of the Shares, we find it difficult to see why the absence of the share certificate should be relevant in considering the viability of a notional sale. The notional sale relates to the bundle of rights which the employee obtained by virtue of his or her employment. Once it is concluded that the employee did acquire rights on a particular day, he is deemed by section 9(4)(a) to have disposed of those rights. The nature of the rights (together with the restrictions attached thereto) would of course be relevant in determining the amount 'which a person might reasonably expect to obtain from a sale in the open market'. That is a valuation exercise to be undertaken in the light of the facts of each particular case.

19. The rights in this case are rights to receive dividends and to vote in a leading bank. Those rights are subject to a five years' restriction against alienation. The Revenue and the Bank are ad idem that the market price of the Shares as at 12 July 2000 should be discounted by 20% to reflect such restrictions. There is however evidence before us indicating that the United Kingdom Capital Taxes Office was prepared to allow a 25% discount to 'reflect the five year restriction period with early release clauses'. The Revenue has not furnished any reason to differentiate the Hong Kong and the United Kingdom positions. We are of the view that a 20% discount is too low in the circumstances. Despite express invitation by this Board, the Appellant did not put forward any other figure. We would follow the English position and direct that tax should be assessed on the basis of a 25% discount of the market value on 12 July 2000.

Our decision

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20. We allow the appeal to the extent as indicated in paragraph 19 of this decision. Save and to the extent as indicated in that paragraph, we confirm the assessment on the Appellant.